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Supreme Court of the United States

OCTOBER TERM, 1931.

NO. 401.

AMERICAN SURETY COMPANY OF NEW YORK,
Petitioner,

v.

THE GREEK CATHOLIC UNION.

BRIEF OF PETITIONER ON QUESTIONS RAISED ON CERTIORARI.

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INDEX.

SUBJECT INDEX.

PAGE

Brief:

Opinions of the court below 1
Jurisdiction 2
Statement of the Case 2
Questions Presented 2
Essential Facts 3
Specification of Errors 5
Argument 7
Summary 7
Introductory statement 8
Point A 1 8
Point A 2 11
Point A 3 14
Point A 4 15
Point A 5 16
Point B general 17
Point B 1 18
Point C 20

TABLE OF CASES CITED.

Guaranty Co. v. Pressed Brick Co., 191 U. S. 416 ... 8

STATUTE.

Judicial Code, Sec. 240, as amended by Act of February 13, 1925 2

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OPINIONS OF THE COURT BELOW.

The opinion of the Circuit Court of Appeals when the case was before it on judgment on the pleadings was written by Buffington, Circ. J., Davis, Circ. J., concurring. Woolley, Circ. J., wrote a dissenting opinion. These are reported in 25 Fed. (2d) 31.

The opinion of the same court in the second appeal, adopting without restating the statement of law made in the former opinion, was written by Buffington, Circ. J., Thomson and Thompson, Dist. JJ., concurring. It is reported in 51 Fed (2d) 1050.

STATEMENT OF GROUNDS ON WHICH JURISDICTION IS INVOKED.

1. The date of the judgment to be reviewed is August 14th, 1931.

2. The petitioner contends that the court below has decided an important question of general law in a way probably untenable or in conflict with the weight of authority. The specific rulings of the lower court relied upon as a basis of the jurisdiction of your Honorable Court are the refusal of the Circuit Court of Appeals to sustain plaintiff's 3rd (R. 201), 5th (R. 202) and 8th (R. 203) assignments of error.

It is believed that the jurisdiction upon this writ is sustained by Section 240 of the Judicial Code as amended by Act of February 13, 1925, c. 229, Sec. 1, 43 Stat. 938 (U. S. Code, p. 906, Sec. 347).

CONCISE STATEMENT OF THE CASE.

The Questions Presented.

1. Whether a surety for compensation upon a treasurer's bond covering *inter alia* his selection of depository is liable as an insurer for subsequent loss of interest on a deposit sustained by the obligee where, after breach of bond, said obligee, in an effort to minimize an anticipated probable loss through failure of depository, entered into an agreement with a new depository to waive interest on its deposit for four years as an inducement to the new depository to take over the business of the former one and avert its failure, said agreement having been entered into without notice to the surety and involving the consequent destruction of the surety's right of subrogation and of the possibility of proving the variance in the risk prejudicial.

2. Whether in such case the loss sustained was due to cause beyond the scope of the bond.

Essential Facts.

This action was begun by suit in assumpsit against George Kondor, principal, and American Surety Company of New York, surety upon his bond as treasurer of The Greek Catholic Union, a beneficial society organized under the laws of the Commonwealth of Pennsylvania.

The bond (R. 35) guaranteed the fidelity of Kondor, bound the obligors to pay loss due *inter alia* (a) to failure of principal to perform his duties as prescribed by the constitution and by-laws of the order, (b) to failure to keep intact and account for funds in accordance with the constitution and by-laws, and (c) failure of depository.

It was alleged, and by jury found, that Kondor had breached his bond, the specific charge being (R. 5-6, 188-189) that he had carried on deposit at Johnstown, Pennsylvania, in a bank of which he was treasurer, an aggregate amount in excess of the limit allowed by the by-laws and excessive in proportion to the assets of the depository bank.

This bank came into financial difficulties. Upon an examination by the banking department of the State of Pennsylvania, the officers of the bank were notified on a Friday or Saturday that unless indicated steps were taken to correct its condition it would not be permitted to open on the following Monday (R. 53-54). The officers of various banks in the city were called into conference with a view to averting failure of the depository. Finally, as an inducement to a trust company to take over and conduct the business of the depository bank, The Greek Catholic Union, obligee of the bond in suit, agreed in writing (R. 179) to allow two hundred thousand ($200,000.00) dollars to remain on deposit with the trust company for a period of four years without interest unless within that period there

was realized from the assets of the depository an amount sufficient to pay all its depository liability. This agreement was made without knowledge or consent of the surety (R. 94) and following it the business of the depository was transferred to and continued by the trust company without interruption (R. 181-184) and without the payment of interest to the fraternal society (R. 84).

Claim was made on the surety upon the alleged loss of the amount of interest on this deposit of $200,000.00 figured at 5.2 per centum (R. 109), to-wit, for the sum of $41,600.00 with interest thereon from date of claim, and payment being refused by the surety, suit on the bond was brought in the Court of Common Pleas of Allegheny County, Pennsylvania, and removed to the United States District Court for the Western District of Pennsylvania (R. 1).

Judgment on the pleadings was entered in favor of the American Surety Company of New York, the surety, by the District Court (R. 1) in accordance with practice under the law of Pennsylvania. This was reversed by the Circuit Court of Appeals (R. 2) in an opinion by Buffington, J., in which Davis, J., concurred, Woolley, J., filing a dissenting opinion, 25 Fed. (2d) 31. The case being remanded for further proceedings, on the first trial the jury disagreed (R. 2), on second trial a verdict was rendered in favor of the plaintiff for forty-six thousand eight hundred ($46,800.00) dollars (R. 2), from the judgment on which, entered against both defendants, an appeal was taken.

On argument, the Circuit Court of Appeals affirmed the judgment of the District Court (R. 208). Petitioner now seeks a review of that affirmance as to the surety.

SPECIFICATION OF ASSIGNED ERRORS TO BE URGED.

1. The Circuit Court of Appeals erred in refusing to find and hold that under all the evidence the verdict should have been for the surety defendant, being the petitioner herein.

2. The Circuit Court of Appeals erred in refusing to find and hold that the material variance of the risk insured by appellant, whereby a new hazard not covered by the bond was sought to be imposed upon appellant and it was deprived of opportunity both for subrogation and for obtaining proof that the variance was prejudicial, constituted a full defense to the claim against the surety.

That is to say:

3. The Circuit Court of Appeals erred in refusing to sustain appellant's 3rd (R. 201), 5th (R. 202) and 8th (R. 203) assignments of error, which are as follows:

> THIRD. The Court erred in its answer to plaintiff's eighth point, which point and the answer thereto are as follows:
>
> 8. If the jury believe from the evidence that the American Surety Company was liable to the Greek Catholic Union, under its surety contract for the loss suffered by the default of its Treasurer, the agreement entered into between the Greek Catholic Union and the United States Trust Company of Johnstown, Pennsylvania, did not relieve or release the American Surety Company from such liability, unless the jury find that the latter agreement created a material variation, or was a substantial change of said surety contract which change made the Surety Company's risk of loss greater than it would have been if said agreement had not been made.

By the Court:

That is Affirmed.

FIFTH. The Court erred in its answer to defendant's first point, which point and the answer thereto are as follows:

1. That under all the evidence the verdict should be for the defendant, American Surety Company of New York.

By the Court:

That is refused.

EIGHTH. The Court erred in its answer to defendant's fourth point, which point and the answer thereto are as follows:

4. The agreement between the plaintiff Union and the United States Trust Company of Johnstown having effected material variance in defendant's contract of suretyship and having permitted the affairs of Peoples State Bank to be liquidated and its assets collected by said Trust Company instead of a Receiver to be appointed by the Banking Department of the State of Pennsylvania, removed from defendant Surety Company all possibility of participation in any salvage therefrom, and of proving said variance to have been prejudicial and said defendant is thereby relieved of the burden of showing that said variance was prejudicial to it.

By the Court:

That is refused.

ARGUMENT.

SUMMARY.

Introductory Statement.

A. Variance in contract of suretyship, introduced by obligee without consent of obligor, releases the latter.

(1) General statement and Reference to Authority.

(2) Error herein originally arose upon improper deductions of fact from pleadings, on appeal from judgment on statutory demurrer.

(3) It was perpetuated through a jury trial and subsequent appeal.

(4) It was impossible for surety to prove or jury to find that the variance was not prejudicial. "It is difficult to prove the consequences of a thing that never happened."

(5) The only testimony upon the question of salvage though favorable to surety is insufficient to determine extent of its prejudice.

B. The loss sustained by plaintiff was not within the scope of the bond sued upon.

(1) The bond covered honesty and fidelity of officer and failure of depository. The loss alleged resulted from a contract of the Union, the insured, with an outside party and independent of the surety contract.

C. The issue vitally affects commercial suretyship, a business of increasing importance and extent touching intimately the life of the people, its cost based upon experience over a period of years with hazards the extent of which has been determined according to legal principles whose application during such period

has been settled. The ruling of the lower Court if affirmed would add an uncompensated burden to outstanding insurance, a hazard incapable of anticipation and a risk incommensurable in ascertaining the cost of future coverage.

Introductory Statement.

There is practically no issue of fact in this case and the questions of law may be reduced to a very narrow compass. Shorn of all unnecessary verbiage, they may be stated as follows:

Whether in the circumstances the action of The Greek Catholic Union in entering into an agreement, Exhibit "F" (R. 179), released the surety on its treasurer's bond, (a) by introducing a material variance of the contract of suretyship without consent of the surety as a result of which the surety is deprived of its rights to subrogation and of the possibility of proving the variance prejudicial, (b) by substituting a risk not within the scope of the bond.

Point A-(1).

From the opinion of Mr. Justice Brown in *Guaranty Co. v. Pressed Brick Co.*, 191 U. S. 416. we take the general statement of the law applying to variance in surety contracts as follows: (opinion p. 423)

> "It is conceded that, by the general law of suretyship, any change whatever in the contract for the performance of which the guarantor is liable, made without his consent, such, for instance, as an extension of time for payment, if made upon sufficient consideration, discharges the guarantor from liability."

Upon the law as thus stated the surety defendant based its defense in the Trial Court and Court of Appeals.

The Greek Catholic Union, plaintiff below, contended that the law as stated did not apply to a contract of suretyship entered into by a commercial surety, unless it were shown that the variance was not only material but prejudicial as well to the interest of the surety.

In an exhaustive search, counsel for the petitioner herein has been unable to discover any case in which the questions here presented have been adjudicated. Perhaps this is due to the comparatively recent entry of commercial suretyship into its present spheres and the rapid extension of the latter. No case has been found where a surety has been held without its consent to proof that it was prejudiced by the very action of the obligee which deprived it of all possibility of such proof, or that after the obligee had seen fit, without the surety's knowledge or consent, to enter into a composition in settlement of an anticipated loss, it could substitute for the original hazard of the bond a fixed loss so incurred and recover such loss from the surety.

The opinion in the case of *Guaranty Co. v. Pressed Brick Co., supra,* sets forth, we believe, the principles of the law applying to the case at bar and the report of that case is referred to as affording a sufficient compendium of the law required for a decision herein.

The action in the case just cited arose upon a bond executed under an Act of Congress to secure performance by a contractor of a contract to construct a federal building. It was conditioned, not only upon the faithful performance of the work, but to promptly make

payment for labor and material supplied thereon. Suit on the bond by one of the material-men was defended by the surety on the ground that plaintiff had extended time for payment of balance due and in accordance therewith had accepted two promissory notes aggregating the amount of said balance.

Counsel for the Brick Company, use-plaintiff, argued that the rule of *strictissimi juris* in interpretation and construction of suretyship obligations did not apply to case of a compensated surety.

The Court, after referring to this and without adopting the proposition of counsel, enters into a discussion of the character of the covenant upon which the action was brought and referring to ordinary guaranty and the knowledge available to the surety of the parties, the terms of their undertaking, character and responsibility, amount for which it may be liable and the like, remarks: (opinion p. 425)

> "In such cases he (the surety) contracts in reliance upon the exact terms of his principal undertaking, and has a right to suppose that no change will be made without his consent; and the courts have gone so far as to hold that any change will exonerate him though it really redound to his benefit."

After discussing the character of the extension of credit given, the opinion proceeds: (p. 426)

> "The facts of this case do not call for an expression of opinion as to whether, if an unusual credit were given and in the meantime the principal obligor had become insolvent or the surety were otherwise damnified by the delay, it might not be exonerated."

By inference it would seem the Court would have affirmed the inverse of this proposition and would have exonerated the surety if an unusual credit had been given or the surety were otherwise damnified.

Point A-(2).

The error complained of in the case at bar had its inception in deductions made by the majority of the Circuit Court of Appeals when the case was before it upon the pleadings alone. Thus from the one averment on the subject found only in paragraph 15 of plaintiff's statement of claim (R. 8) that

> "the Executive Officers and Board of Trustees of the plaintiff having been called together especially for the occasion, and having consulted the agents of defendant, and fully informed them of said facts (that is of the failing circumstances of the depository) agreed to accept the terms of the proposition from the U. S. Trust Co.;"

the Circuit Court of Appeals makes some rather surprising enlargements.

The statement in the majority opinion of the Court, 25 Fed. (2d) 31 (opinion p. 32, col. 2):

> "In pursuance of the requirement of the bond that notice of such loss be delivered to the surety at its Home Office in the City of New York within ten days after such discovery, the Surety Company was at once informed by long distance phone of the situation."

And again (p. 33, col. 1):

> "Confronted on a Saturday by this critical condition which required prompt action before the following Monday morning, the society officers and

> their counsel met that evening at Johnstown and by long distance phone at once told the agent of the Surety Company at Pittsburgh and an executive officer at New York of the situation."

are statements of facts and without foundation in the pleadings before the Court. The effect of these assumptions on the mind of the writer of that opinion are apparent from the concluding words of the last paragraph but one, where the court declares that "the insurer with notice of the loss left the insured to meet the situation alone." There was no loss at the time of the meetings at Johnstown referred to in plaintiff's statement of claim. There was not, nor could have been, any "notice of the loss" as required by the bond. There is no averment in the statement of claim upon which to base the statement that any notice of any contemplated action whatsoever upon the part of the obligee was communicated to the surety. There is no averment in the statement of claim that any communication whatever was had with any executive officer of the surety. Not that this was material in the circumstances of time and matter, but it is of importance as going to the accuracy of the statements of fact on which the Court's decision was based. These statements of the Court probably originated in inferences from remarks of counsel at the oral argument.

This error thus put into writing was perpetuated at the trial of the cause before the jury, and the law as stated by the Circuit Court of Appeals upon assumptions purporting to be drawn from the pleadings was applied by the Trial Court to a very different set of facts brought out by the testimony.

The total evidence on this subject of notice is to be found in stipulation of counsel (R. 94) as to what would

be the testimony of Mr. Davis, of counsel for the obligee if called upon the stand, substantially corroborated by petitioner's witness Benham (R. 138). This stipulation was admitted as a courtesy to Mr. Davis to avoid his going on the stand and thereby, under the rules of the Trial Court, being precluded from taking part in the argument of the case to the jury. Nowhere in the stipulation does it appear that any proposal on the part of any other bank to underwrite the deposits of the unfortunate depository had been made or suggestion of any agreement such as was entered into the following morning by the Union. Although the obligee, the Union, had knowledge of the general situation as early as Friday afternoon (R. 99, 102), no attempt was made to communicate with the surety until two o'clock Sunday morning following, when the Manager of the surety's Pittsburgh agency was called on the telephone and later about ten o'clock Sunday morning, when the Manager of the Claim Department of the Home Office of the Company was called at his residence near New York City. Neither of these men were executive officers of the Company. Mr. Benham, Manager at Pittsburgh agency, held an appointment as Resident Vice President, a title conferred upon him and a number of clerks in his office (R. 137) and other agencies throughout the country in order to enable them to execute certain surety bonds when particularly authorized by the Home Office at New York City and it is admitted (R. 95) that his status was known to Mr. Davis.

Point A-(3).

It is interesting to observe how the error of fact above referred to as having crept into the first opinion of the Circuit Court of Appeals was perpetuated in the second. In a very brief opinion and apparently without any reference to the testimony before it, the Circuit Court of Appeals when the case was last before it said, 51 Fed. (2d) 1050 (opinion p. 1050 col. 2.)

> "This case was heretofore before this Court. Reference to 25 Fed. Rep. (2d) 31 will explain its facts and obviate present repetition."
>
> * * * * * * *
>
> "The former opinion fully discussed the alleged facts and set forth the legal principles to be applied in the case on retrial."

Upon that assumption and upon the bald statement (opinion p. 1051 col. 1) that whether there was a material variance or a substantial change in the surety contract, making the Surety Company's risk of loss greater than if the agreement had not been made,

> "On these questions the jury found for the Union,"

the Circuit Court, without more, affirms the judgment of the Trial Court. Apparently the testimony was never considered. Certainly even a casual reading would have differentiated the facts from those statements of the Court in "the former opinion."

Point A-(4).

How could the jury have found that the agreement entered into by the obligee did not work a material change prejudicial to the surety when the agreement by its very terms deprived the parties of all possibility of ever producing evidence on the subject? As was said by His Honor, Judge Woolley, in his dissenting opinion in this case (25 Fed. (2d) 31), last paragraph but one (p. 34, col. 2),

> "Whether on an issue of prejudice it would appear that the defendant would actually have lost more if resort had first been made to its bond than is now demanded of it and just how much more is a matter that will, from the very nature of the case, always remain in the realm of conjecture. It is difficult to prove the consequences of a thing that never happened."

In view of this situation the argument of the plaintiff below that the surety must show a material variance by which it was prejudiced and the authorities by it cited in support of that proposition would seem to be entirely beside the point and of no avail. There is no case we have been able to find which goes so far as to hold that even a commercial surety is not released by a change in its contract whereby it is deprived of its right of subrogation. That right, in the case at bar, was distinctly conferred by provision 5 of the bond (R. 37). And is it not a singular proposition to assert that an obligee may, by its own act and without consent of the surety, deprive it of all opportunity of proving a variance prejudicial and at the same time demand such proof as a prerequisite to the surety's relief?

Point A-(5).

The only testimony at all on the subject of salvage is that of the plaintiff's witnesses, Cherry and Jendricks, both officers of the United States Trust Company of Johnstown, which had underwritten the depository obligations of the Peoples State Bank, former depository of the plaintiff Union. Cherry testified (R. 65) that he had been cashier of the Peoples State Bank and on pages 69 and 70, that since the closing of that Bank he had been employed by the underwriting Trust Company and had had charge of the collection of the assets of the former depository.

It will be observed that counsel began his interrogation as to these assets (R. 69):

"Q. Mr. Cherry, you are still interested, I believe, in the collection of these notes and securities that were listed in your report?

A. I am."

This was followed by the questions as to amounts remaining "uncollected" at certain times. In the last question, in an effort to ascertain the amount uncollected at the time of the trial, when the question was repeated the word "uncollectible" was substituted. The answer "$98,000.00, unconverted," was not categorical and in view of Cherry's statement as above that he was still interested in collection of the assets, it cannot be assumed that he intended to convey his opinion that the amount of $98,000.00 was uncollectible, but simply that it was as yet unconverted.

Mr. Jendricks, Treasurer of the United States Trust Company, in his testmony (R. 74) stated:

"Q. And there is still a considerable amount outstanding?

A. Yes, sir, uncollectible."

He was not interrogated as to amounts. But he was Cherry's superior officer and heard the testimony of the latter that he was still interested in the collection of assets of the Peoples State Bank. Is it not a reasonable inference that he would not have assigned Cherry to a futile task and that the expectation of realization from the "$98,000.00 unconverted" must have justified Cherry's labor?

And having in mind the total assets of the depository when it was absorbed on April 7, 1924, being Cherry's "$320,000.00 uncollected" securities plus the cash, real estate and equipment, Exhibit "E" (R. 177), if there is any fair inference to be made, it would seem to indicate that efficient administration may yet result in a profit to the bank that underwrote the deposits.

Point B.

Reference again to the opinion in *Guaranty Co. v. Pressed Brick Co., supra,* and to the last sentence of the last paragraph but one indicates the caution with which this Honorable Court has approached in the past any question of disturbing well settled rules of law.

After remarking, that an insurance contract undertaken for profit should be interpreted liberally in favor of the insured, the Court adds:

> "Of course this rule would not extend to cases of fraud or unfair dealing on the part of (the insured) * * * or to cases not within the scope of the undertaking."

Point B-(1).

The bond upon which this suit is based appears as Exhibit "C" (R. 35). It is a standard form known as "F 15 Fraternal Continuous Schedule Subordinate Officers" (R. 39) and by its terms the surety binds itself to pay to the obligee such pecuniary loss as it shall have sustained of money, funds, securities or other personal property.

(a) through fraud, dishonesty, etc., on the part of the officer or employee bonded,
(b) through failure of such officer faithfully to perform his duties as prescribed by the constitution and by-laws of the order,
(c) through failure of the officer or employee to keep intact and account for funds of the order,
(d) through failure of a depository.

In paragraph 5 of the provisions, it is agreed that in event that the loss under any suretyship exceeds the amount of such suretyship, the order and the surety shall share with each other pro rata in any net recovery, except from other suretyship, in a proportion that the amount of payment under the suretyship bears to the total shortage.

Under the terms of the bond, as in the case of an ordinary guaranty bond discussed in *Guaranty Co. v. Pressed Brick Co., supra,* the guarantor understood perfectly the nature and extent of its own obligation, its liability upon breach of the bond by the officer or upon failure of the depository to pay the amount of loss so occasioned and its right thereupon to be subrogated to the rights of the obligee to claim and receive any property, securities, payments or dividends upon which the obligee would have had right to make a claim.

There was no claim of violation of paragraph (a) of the bond. The Union claimed its Treasurer had breached his bond by depositing funds in excess of limitations under its by-laws in a bank that was not a safe depository for such amounts and that this breach of paragraph (b) constituted also a breach of paragraph (c) of the bond.

No claim was made under paragraph (d). The depository liability on the bond never accrued for the reason that the depository did not fail. It was not allowed to fail. Had the depository been closed by State Banking officers the surety would have paid its depository liability and would have been subrogated to the right of the obligee to participation in distribution of the assets of the depository and who could now say that it would not have been reimbursed in full for its expenditures?

It seems preposterous to assert that the bond in question contemplated coverage of a hazard so uncertain and highly speculative as a fixed loss which the obligee might bring upon itself through its voluntary effort, by some substituted arrangement, to minimize an anticipated loss covered by its surety bond. That no experience over any number of years could afford a basis for the collection of a premium to cover the hazard of loss which an obligee might thus be persuaded to assume without the consent of the surety, seems to find a complete answer in a mere statement of the proposition. Is there more required to justify the suggestion that such a hazard is not within the scope of the bond sued upon?

Point C.

The importance of these questions to the business of fidelity and similar suretyship is apparent when one considers that the rates charged by way of premium must be calculated and laid in an amount sufficient to cover the risk and compensate the surety for its service.

The requirements of modern business for this class of suretyship have exceeded for many years the possibilities of individual suretyship. To meet the demand of business, law and the social organization in general for a form of insurance providing safety at a reasonable cost the commercial surety companies have come into being within comparatively recent years and their business has increased so rapidly that there are today outstanding millions of dollars of fidelity and depository insurance covering a vast portion of the Nation's business.

The settlement of the law relating to suretyship and the uniformity of decision is, therefore, of large moment. The insurance outstanding today is based upon the law as it has been heretofore declared and calculations of the risks and hazards covered by the various forms of bonds have been made upon the basis of experience of loss under the legal obligations as heretofore applied to said suretyship. Skilled actuaries have calculated the rates over an experience of many years.

That the relaxation hertofore accorded the rule of *strictissimi juris* in interpreting and construing the contracts of compensated sureties is a necessary and proper evolution of the law of suretyship is hardly subject to question in view of the uniformity of the decisions to that effect. ***But the ruling in the present case carries this relaxation beyond a danger point in that it adds an***

additional hazard, uncontemplated when the insurance was written; imposes upon the surety a burden against which it is not secured and for the assumption of which it is not compensated in its outstanding contracts; and adds liability for a class of speculative risks the cost of whose coverage is probably not susceptible of calculation.

That the affirmance of the principle laid down by the Court below would be deplorable and perhaps disastrous to the surety business through the disturbance of rate schedules and increased cost of bonds for such suretyship is readily apparent. But even this is of minor importance, if the law of the land shall be held to permit the beneficiary of an insurance contract, such as that involved in this case, to change the contract at will without notice to or consent of the insurer and upon a suit for such loss as he may bring upon himself to say:

> "It looked to me as though both of us were going to lose so I went ahead, without notice to you or your consent, and settled the matter by taking a definite loss which you must pay unless you can prove to me that you were prejudiced by my act. Why should you object that I have put it out of the realm of possibility for you to show that you were prejudiced and deprived of any opportunity for reimbursement by way of subrogation, which would otherwise have been yours?"

Respectfully submitted,

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